P-421/EM-93-1320 ORDER REJECTING PROPOSAL TO OFFSET CONTRIBUTION FROM CLASS SERVICES WITH RATE REDUCTIONS

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Don Storm	Chair
Tom Burton	Commissioner
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In the Matter of a Proposal by US WEST Communications, Inc. to Offer CLASS Services

ISSUE DATE: January 18, 1995

DOCKET NO. P-421/EM-93-1320

ORDER REJECTING PROPOSAL TO OFFSET CONTRIBUTION FROM CLASS SERVICES WITH RATE REDUCTIONS

PROCEDURAL HISTORY

I. The Initial Order

On April 12, 1994 the Commission issued an Order approving with modifications US WEST Communications, Inc.'s proposal for offering CLASS Services in most of its exchanges in the seven-county metro area and in its Gaylord and LeSueur exchanges. That Order also opened an inquiry into a proposal by the Department of Public Service (the Department) and the Residential Utilities Division of the Office of the Attorney General (the RUD-OAG) to offset the contribution expected to result from CLASS services with rate reductions in other service categories.

The Commission accepted the recommendation of the parties to defer consideration of the contribution issue until it had acted on the Company's application to offer CLASS services. The April 12 Order therefore authorized staff to establish comment periods on the offset proposal and to bring the matter before the Commission when adequately developed.

The contribution issue came before the Commission on December 20, 1994.

FINDINGS AND CONCLUSIONS

II. Incentive Plan Background

Effective January 1, 1990 US WEST began operating under an incentive regulation plan approved by the Commission under Minn. Stat. § 237.625 (1992). Incentive regulation is a form of alternative regulation designed to increase companies' incentives to operate more efficiently. Under incentive regulation a company is allowed to earn amounts in excess of its authorized rate of return, subject to a requirement to return a specified percentage of excess earnings to ratepayers.

A company operating under an incentive plan cannot raise its rates except under carefully limited circumstances. Under US WEST's plan, the Company cannot raise its rates across-the-board without establishing that its rate of return on equity has fallen below 10%, a level significantly below that which would normally support a general rate increase.

Similarly, the Commission cannot order an across-the-board rate reduction no matter how much the Company earns. Instead, earnings above a specified threshold (13.5% return on equity) are shared equally between shareholders and ratepayers. Earnings above a higher threshold (18.5%

return on equity) are refunded to ratepayers in full.

Although companies operating under incentive plans cannot file general rate cases, they may petition to change rates for individual services. The Commission may also change rates for individual services while a plan is in force.

Rate changes approved or ordered during the life of US WEST's plan have often been designed to be income-neutral, primarily for two reasons. One is that fairness precludes exploiting the Company's inability to file a rate case. The other is to honor, as far as possible, the statutory goal that a company's financial performance should reflect its operating efficiency, not the workings of the regulatory process.

III. The Offset Proposal

The RUD-OAG and the Department have urged the Commission not to treat US WEST's earnings from CLASS services as normal earnings, subject to sharing with ratepayers under the incentive plan, but to offset them with rate reductions for other noncompetitive services. They support their proposal with the following arguments:

(1) Offset is consistent with the income-neutral treatment often given rate changes under the incentive plan;

(2) Since CLASS revenues may be large and CLASS equipment was purchased with money collected from ratepayers, offset is required by fundamental fairness;

(3) Since many components of CLASS services were available under different names before CLASS services were introduced, CLASS services tariffs can be viewed as a conglomeration of rate change tariffs instead of new services tariffs.

The Company opposed the offset proposal, claiming it was a pretense for the earnings investigation the parties really sought but could not propose during the life of the plan.

IV. Commission Action

The Commission finds the offset proposal inconsistent with the intent of the incentive plan statute and the US WEST incentive plan approved by the Commission. Earnings from

CLASS services will be treated in the same way as other Company earnings, subject to sharing with ratepayers only under the terms of the plan. The arguments for offset are examined below.

A. History of Income Neutrality in Rate Adjustments

The Department and the RUD-OAG are correct in stating that the Commission has often approved or required income neutrality for rate changes while the incentive plan has been in force. When the Commission required elimination of the metropolitan tier rate structure, for example, the Order directed the Company to implement the rate change in an income-neutral manner.[1] The Commission has also approved Company-proposed rate adjustments designed to achieve income neutrality.

Income neutrality makes sense in the context of rate changes. Since the Company cannot raise rates across the board, it is understandably wary of losing financial ground on miscellaneous rate adjustments, and tends to seek income neutrality. The Commission is equally wary about incrementally lowering or raising Company revenues, when they cannot be adjusted in a subsequent rate case or earnings investigation.

Rate changes and new services are different, however. New services are supposed to be one of the benefits of incentive regulation; the Commission has not required income neutrality when the Company has introduced other new services. Incentive regulation is based on the theory that releasing companies from regulatory controls and allowing earnings to vary with performance will mimic the effects of competition, unleash creativity, and produce the benefits of a competitive market, including lower rates and new services.

Incentive regulation would provide no incentive for new services if those services were treated as they were under traditional regulation, that is, if they carried no potential for increasing company revenues and earnings. For this reason, the plan approved by the Commission made all noncompetitive and emergingly competitive services, not just existing services, subject to the sharing operations of the plan.

The Commission, like the Company, is bound by the terms of the plan and will not impose income neutrality where the plan requires only sharing of earnings.

B. The Appeal to Fairness

The Commission rejects the argument that the potential magnitude of CLASS earnings places them in a special category outside the operation of the incentive plan. The incentive plan is the regulatory mechanism under which the Company operates. Its terms and conditions bind Company and Commission and govern how these and other earnings will be treated. The possibility that the Company will earn more than its authorized rate of return is a fundamental feature of incentive regulation and of this plan.

After extensive public input, the Commission determined the Company may keep earnings up to a return on equity of 13.5%, must share earnings between 13.5% and 18.5% equally with ratepayers, and must refund to ratepayers earnings in excess of 18.5%. These issues are no longer open to question.

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[1] In the Matter of the Petitions of Certain Subscribers in the Exchanges of Zimmerman, Prescott, Waconia, Belle Plaine, North Branch, Lindstrom, New Prague, Cambridge, Hudson, Houlton, LeSueur, Cannon Falls, Delano, Northfield, Buffalo, and Watertown for Extended Area Service to the Minneapolis/St. Paul Metropolitan Calling Area, Docket No. P-421, 405, 407, 430, 426, 520, 427/CI-87-76, ORDER ELIMINATING METROPOLITAN TIER RATE STRUCTURE OF U S WEST COMMUNICATIONS INC. AND ESTABLISHING COMMENT PERIOD TO CALCULATE NEW UNIFORM RATE (December 20, 1991).

The Commission also rejects the notion that ratepayers have a special claim on CLASS earnings because CLASS services are noncompetitive and CLASS technology was purchased with money collected from monopoly ratepayers. This argument conflicts with the clear purpose of the incentive regulation statute, which is to experiment with giving telephone companies the opportunity to earn more than their revenue requirement. For all companies, most of their revenue requirement is still attributable to rates for monopoly services.

Furthermore, CLASS services are not uniquely linked to or funded by monopoly rates. US WEST's last general rate proceeding was concluded in 1987.[2] Obviously, many CLASS investments were made after that time and were not included in the rates and revenue requirement set in that case.

Furthermore, the Company's incentive plan requires the Company to upgrade 88 rural central offices, significantly increasing the range of services and potential revenues of those exchanges, without requiring rate reductions to offset net revenue increases. It is hard to see the logic of requiring offset of net CLASS revenues and not upgrade revenues on any basis other than the projected size of the revenues. As explained above, the size issue has already been addressed by setting the sharing (13.5%) and refund (18.5%) thresholds.

C. Repackaging Existing Services

The Department also suggested the Commission could base a decision to offset net CLASS revenues on the theory that CLASS services were in part existing services offered in new combinations, making CLASS services more like a conglomeration of rate changes than a new service offering. The Department did not itself concur in this argument, but believed the Commission's original CLASS Order offered some support for that view.[3]

That Order's reasoning on the regulatory classification of CLASS services, which found that some CLASS services were variations and refinements of existing services or service elements, has been superseded by legislative action finding CLASS services noncompetitive.

Furthermore, experience with actual CLASS filings has demonstrated that CLASS technology and delivery systems have so transformed old services and service elements that meaningful rate comparisons are impossible. In short, CLASS services, whatever their historical antecedents, do not correspond closely enough with old services to treat CLASS tariffs as a conglomeration of rate adjustments.

D. Conclusion

For all the reasons set forth above, the Commission will reject the offset proposal of the Department and the RUD-OAG. Net CLASS earnings will be subject to the sharing provisions of the incentive plan on the same terms as other Company earnings.

ORDER

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[2] In the Matter of a Petition by the U. S. Department of Defense, the General Services Administration, and All Other Federal Executive Agencies of the United States Challenging the Reasonableness of the Rates Charged by Northwestern Bell Telephone Company, Docket No. P-421/CI-86-354.

[3] In the Matter of a Commission Initiated Investigation into the Provision of Custom Local Area Signaling Services in Minnesota, Docket No. P-999/CI-92-992, ORDER ESTABLISHING CONDITIONS FOR THE PROVISION OF CUSTOM LOCAL AREA SIGNALING SERVICES (June 17, 1993).

1. The proposal to offset contribution from CLASS services with rate reductions for other noncompetitive services is rejected.

2. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)